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TREASURY FOR INTERNATIONAL AFFAIRS - JON ROSE

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TAGS: EFIN ECON PGOV TU
SUBJECT: TURKEY: BUSINESS INCREASINGLY WORRIED BY POLITICAL CONFUSION

REF: ANKARA 1015

Classified By: ECON/C Tom Goldberger. Reasons 1.4 (b) and (d)

This cable has been coordinated with Congen Istanbul.

¶1. (C) Summary. Turkish markets and businesses remain hopeful that a resolution will be found to the ongoing political turmoil. Market movements are subdued and direct investment continues to flow in. But more fundamentally, businesspeople worry that prospects for a political outcome that would allow economic reform to continue are becoming less certain. In particular, they are less convinced that uncertainty would be eased by early parliamentary elections. Thanks to a favorable global market environment and the relatively good financial position of the government, banking and business sectors, a sudden market crisis seems unlikely at the moment. But this could change over time if global sentiment turns sour or if the political climate deteriorates further. End Summary.

Portfolio and Direct Investment Continues to Come

¶2. (SBU) Business goes on despite the sound and fury in Turkey's political world. Financial markets dropped 8% April 30-May 1, the two working days following the April 27 posting on the Turkish General Staff's website, but have since recovered nearly all of that loss. In a favorable global emerging market context, financial markets have been driven by inflows from foreign portfolio investors. Even a negative domestic inflation report on May 3 did little to dampen foreign enthusiasm for Turkish financial assets, although it did bring a small fall in inflation-sensitive domestic bond prices. Istanbul-based financial analysts note that with nominal yields at 18% portfolio investors need "more than just one or two reasons to not like Turkey." The Turkish lira weakened against the dollar on the initial reports from 1.33 to 1.38, but has also recovered. In this respect Turkey is hardly the sole emerging market benefiting from the abundance of global liquidity. One analyst mentioned how countries like Serbia or Romania continue to attract portfolio investment despite domestic political problems.

¶3. (SBU) Direct investment has continued to flow in. Investor demand was strong for the controversial partial privatization of Halk Bank (septel). The Privatization Administration also concluded a $1.3 billion sale of the management contract for Izmir's port to Hong Kong-based Hutchinson-Whampoa. Fiat announced the first ever launch

of a global car brand in Turkey in a 170 million euro partnership with Turkish industrial conglomerate Koc. From the US, Citigroup's venture capital arm concluded an equity investment in an upscale clothing retailer and eBay took a minority stake in a Turkish auction website "Gitti Gidiyor" (going-going-gone!)

¶4. (C) In another sign of business confidence despite the rough political seas, the GOT signed a letter of intent to the International Monetary Fund that will allow the sixth review of the IMF stand-by program to go ahead this month. The local IMF representative told us that it was the Fund's judgment that the policy commitments of its largest single client "remained credible." Leading business associations like TUSIAD, TOBB, MUSIAD and YASED (foreign investors association) and regional chambers of commerce and industry similarly express confidence that political tensions will be resolved constitutionally. In particular, they welcome the move to early parliamentary elections, which would shorten the period of uncertainty. The best scenario for business and financial markets may be, one analyst told us, a coalition between AKP and the new merger of the center-right DYP and ANAVATAN parties. The plausibility of this scenario may help explain the business community's relatively serene reaction to recent political events.

Private Worries Grow

¶5. (C) But privately, the tone among local businesses is

appreciably more concerned than it was a week ago. Along with market analysts, they point to an impression that the outcome of the political crisis is becoming more, not less, uncertain as time goes on. The overarching worry is a return to the political gridlock that characterized Turkish politics in the 1980s and 1990s and which the market-oriented policies of a single-party AK government brought welcome relief. Even if they are wary of AKP's suspected social agenda, business has strongly supported its economic agenda. A return to policy paralysis would block the economic reform program and perhaps even lead to a retreat from pro-market policies.

¶6. (C) The major opposition parties, CHP and MHP, are seen as very market unfriendly, and the other opposition parties as only slightly less so. The anti-US, anti-IMF, and anti-EU slogans at 'secularist' demonstrations in Ankara, Istanbul and elsewhere are frequently cited. This makes it hard to envisage a forward-leaning policy environment emerging from a multi-party government. On the other hand, a return of a large AKP majority holds the risk of confrontation with the military which is also a bad scenario for business. Hence the attraction of an AKP-led coalition including the secularist center-right which could continue AKP's economic policies but allow a secularist veto.

¶7. (C) Comment. The Turkish government, banking and business sectors have taken advantage of strong growth since 2002 to build up a cushion of reserves (ref). This is sufficient to weather a short-term market downturn and outflow of portfolio investment. There are also recent signs of a moderation in Turkey's large current account deficit, which has been considered one of the greatest economic vulnerabilities. The March current account deficit came in better than expectations, and in the first quarter of 2007, exports are growing more quickly than imports. Both the reserve picture and the moderating current account

help cushion against a sharp outflow.

¶8. (C) Unlike the most recent market correction in May-June 2006, confidence is being supported by a favorable global environment that is swamping local negatives. If this global environment were to flip, the negative impact would be magnified in Turkey, given its high exposure to international markets (a $30 billion per year -- 8% of GDP -- external borrowing need) and high risk perceptions. At the same time, the current unpredictable climate offers multiple opportunities for the climate of political confrontation to build. The nightmare scenario of the moment is a loss of global appetite for Turkey combined with a sustained lack of political accommodation. In this case, Turkish investors, who are already more sensitive to political risk than foreigners as shown by the growth in local foreign exchange holdings over the past year, would join a rush for the exits.

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